

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

)	
Investigation by the Department on its own)	
Motion into the Appropriate Regulatory Plan)	
to succeed Price Cap Regulation for Verizon)	D.T.E. 01-31 Phase II (Track B)
New England Inc. d/b/a Verizon Massachusetts')	
intrastate retail telecommunications services)	
in the Commonwealth of Massachusetts)	
)	

INITIAL BRIEF OF VERIZON MASSACHUSETTS

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DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

D.T.E. 01-31 Phase II (Track B)

Verizon Massachusetts (“Verizon MA”) submits this Initial Brief in support of its Alternative Regulation Plan (“Plan”),¹ filed on June 5, 2002, in compliance with the Department’s Order in Phase I of this proceeding (Exh. VZ-1). D.T.E. 01-31 – Phase I (May 8, 2002) (“*Phase I Order*”).

¹ In compliance with the *Phase I Order*, the Plan includes terms and conditions for intrastate services offered in Massachusetts to business and residential customers. Because the Department bifurcated its investigation of the Plan into Track A (business services) and Track B (residential services), the Plan referred to in this Initial Brief on Track B addresses those elements relating only to residential services.

greater sensitivity to customer demands. *Id.* As the Department has noted “if effective competition exists, no rate regulation whatsoever ... would be needed.” *Id.*, at 113.

In the *Phase I Order*, the Department found that sufficient competition exists for most Business services to grant Verizon MA market-based pricing flexibility, subject only to a price floor constraint. With respect to Residence services, although the Department concluded that there is competition for these services, and that competition for them is growing (*Phase I Order*, at 104), it did not grant Verizon MA the same level of pricing flexibility as for Business services. Rather, the Department determined that Residence Basic services should remain subject to price regulation and tentatively concluded that price increases for these services should be limited at this time to 5 percent per year. *Phase I Order*, at 102-103. The Department also tentatively concluded that pricing flexibility for Residence Non-Basic services should be continued.

Verizon MA’s Plan is supported by record evidence that confirms the Department’s tentative conclusions regarding the regulation of Residence services. As the record demonstrates, providing Verizon MA with the ability to increase rates for Residence Basic services by a modest 5 percent annually furthers the Department’s goal of more market-based and efficient pricing of telecommunications services. Residence Basic service prices are well below efficient competitive levels, and such prices forestall competitive entry to the detriment of all consumers in Massachusetts. A 5 percent increase is substantially less than the price increases implemented by the Department in D.P.U. 89-300 and meets the Department’s objective of rate continuity. At the same time, Verizon MA’s Plan furthers the Department’s goal of universal service by maintaining the rates for LifeLine customers at the existing levels so that customers who take advantage of this discount program will see no increase in their rates. In short, Verizon MA’s Plan should be approved because it will result in just and reasonable rates,

consistent with the policy objectives that the Department has traditionally used for assessing changes in regulatory requirements.

The only party objecting to Verizon MA's proposal is the Attorney General. His objections to the Plan are without merit. The Attorney General's reliance on outdated and imprecise tools, such as embedded cost allocation studies, is irrelevant in today's competitive environment. The current competitive markets for telecommunications services, including Residence services, require creative and flexible pricing by all carriers – not regulatory debates about the arbitrary allocation of historical costs, as the Attorney General suggests. Indeed, the Attorney General's position reflects a regulatory theory for pricing retail services that the Department abandoned in 1995 with the adoption of its Price Cap Plan in D.T.E. 94-50 and ignores the reality of today's competitive telecommunications markets.

As Verizon MA has shown here, the potential annual increase of 5 percent authorized under the Plan for Residence Basic services will further economic efficiency and enhance competition by permitting Verizon MA to recover – if market conditions allow – a more equitable portion of its joint and common costs from those services. Verizon MA's implementation of the Department's tentative conclusions is a measured and appropriate transition to market-based price regulation of Residence Basic services, while balancing other Department objectives, such as rate continuity and universal service. The Department should approve the Plan as filed.

I. DESCRIPTION OF VERIZON MA'S PLAN

In its *Phase I Order*, the Department determined that Verizon MA's Residence Basic services should remain subject to an alternative form of regulation, and Residence Non-basic services should continue to have their current degree of pricing flexibility. *Phase I Order*, at

100-104. Consistent with the Department’s finding, Verizon MA’s Plan divides Residence services into Basic and Non-basic services. Residence Basic services include the Residence Dial Tone Line charge, Residence measured usage charges and the usage associated with Unlimited usage, Metropolitan usage, Suburban usage, Circle usage and Expanded Community Calling service (Exh. VZ-2, at 6). Non-basic services are all other residence services. A complete list of Basic and Non-basic services is found in Attachment A and B of the Plan (Exh. VZ-1, Tab A).

Verizon MA’s Plan provides that, following implementation of the Department-ordered revenue-neutral adjustment to the Dial Tone Line rate to account for elimination of charges for Touch Tone service and reductions in Intrastate Switched Access prices, rate increases for Residence Basic services will be limited to 5 percent per year (Exh. VZ-1, Tab A at ¶ A).² In order to maintain the rates for LifeLine customers at the existing rate levels, Verizon MA proposes that the LifeLine credit be increased in an amount equal to the increase in the Dial Tone Line rate (*id.*, at ¶ D). As a result of the increase in the LifeLine credit, no LifeLine customer will see any increase for basic service. Similarly, under the Plan, any future increase in the Dial Tone Line rate will result in an equal increase in the LifeLine credit, thereby ensuring no increases in the basic charges for LifeLine customers.

For Residence Non-basic services, prices could increase or decrease in response to market conditions on a 30-day notice, at Verizon MA’s discretion, subject to the appropriate price floor rules (*id.*, at ¶¶ E, P, S). This rule is in keeping with the Department’s long-standing view that such services “are considered to be a luxury” and thus should be “priced based on

² In addition, Verizon MA proposes to make all price-regulated service prices subject to change if events beyond the control of the firm (“exogenous events”) are shown to increase or decrease Verizon MA’s costs or revenues. In unregulated competitive markets, the analog of exogenous events that affect the industry are passed through to consumers by market forces and reflected in the prices consumers pay. For exogenous events that affect the regulated company (*e.g.*, an economic event or regulatory change specific to the firm), Verizon MA’s proposal ensures that such increases or decreases in cost are reflected in the prices consumers pay. Moving prices in the same direction as costs increases economic efficiency.

market conditions and revenue-maximization.” *Phase I Order* at 104. The same degree of pricing flexibility would apply to new Residence services (Exh. VZ-1, Tab A, at ¶ E).

In compliance with the *Phase I Order*, the present Residence Dial Tone Line rate is increased to offset the reduction of Switched Access charges to the July 2002 interstate rate levels and to offset the net reductions of other rate changes associated with the elimination of a separate residence Touch Tone charge and an adjustment to the Residence Dial Tone Line charge to increase the LifeLine credit (Exh. VZ-2, at 6-7).³ No party has questioned Verizon MA’s calculation of the Department-ordered offsets. In the *Phase I Order*, the Department also determined that certain services previously considered retail services were in the nature of wholesale services that competitors use to compete with Verizon MA’s offerings. In particular, the Department identified Public Access Lines (“PAL”) and Public Access Smart Lines (“PASL”) services,⁴ collocation⁵ and Special Construction as wholesale offerings that should be priced at UNE-like rate levels. *Phase I Order*, at 94-95. Consistent with the Department’s historical rate rebalancing effort, the decreases in these rates are made on a revenue-neutral basis by corresponding changes in the Residence Dial Tone Line rate. Here too, no party raised any

³ The calculation of these adjustments is contained in Tab B of Verizon MA’s June 5, 2002 Compliance Filing (Exh. VZ-1) and has been updated to reflect the actual July 2002 interstate Switched Access rate levels in Attachment A of Exhibit VZ-2.

⁴ For PAL and PASL services, Verizon MA provided prices recalculated to reflect UNEs. However, the Department has a pending docket (D.P.U./D.T.E. 97-88/97-18 (Phase II)) in which it is examining PAL and PASL rates under the FCC’s requirements in Section 276 of the Telecommunications Act. Verizon MA recommends that the results of the Department’s order in that docket be incorporated into the Plan, rather than adopting the UNE-like rates that Verizon MA filed in compliance with the Department’s directives in the *Phase I Order*.

⁵ The Department directed that Verizon MA reprice collocation services provided under DTE No. 10, Section E to the relevant UNE offering in DTE No. 17. The collocation offerings in DTE No. 10, until recently, were available to both carriers and end user customers. On May 23, 2002, the Department approved Verizon MA’s proposal to grandfather the tariff, and therefore, no new services are being provided under that tariff. Currently, there are 34 circuits provided under DTE No. 10. Verizon MA will convert the existing circuits provided to carriers to the relevant UNE offering in DTE No. 17. The revenue effect of repricing these collocation arrangements is -\$15,925, as shown at Tab B, Attachment V of Verizon MA’s Compliance Filing. For the few remaining collocation circuits (three circuits), Verizon MA proposes

issue concerning Verizon MA's calculation of the offsets. As a result of these revenue neutral rate changes, the Residence Dial Tone Line rate is increased from \$9.91 to a new rate of \$12.35 (Exh. VZ-2, at 12). The 5 percent annual increase permissible under Verizon MA's Plan would apply to the new Dial Tone Line rate as well as other rates within the Residence Basic category.

II. THE DEPARTMENT SHOULD ADOPT VERIZON MA'S REGULATORY PLAN FOR RESIDENCE SERVICES.

Since 1985, the Department has been consistently guided by its policies of furthering competition and adapting the form of regulation it exercises over Verizon MA to reflect changing competitive conditions in markets. For instance, when the Department adopted the Price Cap Plan in D.T.E. 94-50, it stated that, although the plan was appropriate in a market that was moving toward more competition, price-cap regulation was not appropriate for a market exhibiting the presence of effective competition. The Department reiterated that if there is sufficient competition, market-based pricing would replace rate regulation by the Department. D.P.U. 94-50, at 113-115. Since that time, telecommunications markets have continued to evolve, and significant changes have taken place as a result of the continuing growth of competition and the implementation of the Telecommunications Act of 1996 (Exh. VZ-2, at 5). In light of these changes, the Department has recognized the new competitive marketplace, and as it has in the past, adapted its regulatory framework for both Business and Residence services to reflect evolving market conditions.

The Department's recognition that competition – not government regulation – is the best way to achieve its policy goals for the telecommunications industry in Massachusetts is reflected in its findings in the *Phase I Order*. The Department ruled that there was sufficient competition

to continue providing them under the grandfathered DTE No. 10, as these circuits are provided to retail customers, and therefore, should not be priced at wholesale rate levels.

for most Business services and granted Verizon MA market-based pricing flexibility for these services. *Phase I Order*, at 92-93. The Department also recognized that there was competition in the Residence market, which was growing. *Id.*, at 104. It did not, however, analyze the extent of competition in this market, as it had for Business services, because Verizon MA did not seek in its initial filing in April 2001 to have Residence services declared sufficiently competitive.⁶ Instead, the Department tentatively concluded that Verizon MA should have a degree of pricing flexibility for Residence Basic services that would be capped at a 5 percent annual increase. Although the extent of that flexibility is very limited, Verizon MA has adopted this pricing limitation in its Plan.

A. The Residence Basic Service Rate Cap Furthers the Department's Objectives And Is A Reasonable Transitional Mechanism.

Verizon MA's witness, Dr. William Taylor, testified that the Department should evaluate Verizon MA's Plan using the same goals and objectives that it has historically relied on whenever it has considered the appropriate form of regulation given the state of telecommunications markets:

... the Department (i) seeks to obtain rates that are efficient, and fair and that do not inhibit the maintenance of universal services and (ii) recognizes that competition will foster efficient prices more readily than will regulation.

(Exh. VZ-3, at 11).

⁶ The Department did not specifically address competitive conditions in the Residence market. However, many of the factors that led the Department to conclude that the Business market was sufficiently competitive also exist in the Residence market. For instance, CLEC supply elasticity is high in both Business and Residence markets because the Telecommunications Act removed all legal, regulatory, and market-based barriers to entry by allowing resale of Verizon MA's services at avoided-cost rates, and by allowing UNEs to be leased at total-element, long-run, incremental cost ("TELRIC") rates.

Verizon MA's proposed regulatory plan for Residence Basic services fully satisfies these goals. The record in this case establishes clearly and convincingly that the cap is reasonable because it enables Verizon MA to move Residence Basic service rates to more economically efficient levels, if market conditions warrant, without jeopardizing the Department's universal service policy. By giving Verizon MA some Residence pricing flexibility, the Department also furthers its policy of letting market forces, rather than regulatory fiat, determine efficient prices (Exh. VZ-3, at 8-9). Given the extent of competition in the Residence market, Verizon MA's Plan may provide for too slow a transition to market-based pricing of Residence Basic services. AT&T's witness, Dr. John Mayo, argued that the Department should, in fact, increase the 5 percent cap because "limiting the potential for price increases to no more than five percent per year, this rule could prove to continue to be an impediment to the development of competition in the provision of residential local exchange services in Massachusetts" (Exh. ATT-1, at 18). Although greater flexibility is warranted given today's market conditions, Verizon MA's Plan provides the appropriate balance at this time for achieving the Department's policy objectives.

1. Verizon MA's Plan Allows for More Economically Efficient and Fair Pricing of Residence Basic Services.

The 5 percent annual cap on potential Basic Residence rate increases is reasonable for several reasons. Perhaps most importantly, pricing flexibility, although very limited, gives Verizon MA the ability to increase rates, if appropriate, to continue the long-standing Department objective of a transition to more competitive, economically efficient Residence service prices.

The Department has repeatedly determined that "[i]n competitive markets for telecommunications services, efficient market prices are based on incremental cost plus a mark-up for joint and common costs, based on Ramsey pricing principles." *Phase I Order*, at 101,

citing D.P.U. 94-50, at 249 n. 144. Pursuant to Ramsey pricing principles, joint and common costs are recovered from services in inverse proportion to the demand elasticity of particular services. (*Id.*) Verizon MA presented un rebutted evidence in this case demonstrating that the Residence Dial Tone Line rate is far below an economically efficient level because it fails, by a significant margin, to provide a comparable level of contribution toward the recovery of Verizon MA's joint and common costs as other services.

In her Rebuttal Testimony, Ms. Brown presented several detailed analyses showing the relative levels of contribution for a wide range of Verizon MA services. (Exh. VZ-5, Attachments A and B). Attachment A to Ms. Brown's testimony contains an analysis showing the contribution by rate element for Verizon MA services using as the cost standard Marginal Cost Study VI – Verizon MA's last approved marginal cost analysis from 1994. Ms. Brown's analysis demonstrates that the current Residence Dial Tone Line rate (including the federal Subscriber Line Charge) produces a margin above direct costs of only about 22 percent (Exh. VZ-5, Attachment A, at 1). This is substantially below the margins for virtually all other services. Moreover, even when the Residence Dial Tone Line rate is increased, as directed by the Department in this case, to offset reductions in Switched Access charges, other wholesale rates, and the elimination of a separate residence Touch Tone charge, the margin above direct cost increases only to about 40.5 percent – still well below the contribution produced by virtually all other services (*id.*)

Attachment B of Ms. Brown's Rebuttal Testimony compares costs for the Residence Dial Tone Line and Residence usage with the 1997 TELRIC costs developed in the *Consolidated Arbitrations* (Exh. VZ-5, Attachment B). The comparison shows two important facts. First, MCS VI and the more current 1997 TELRIC study produce cost results that are directionally the

same for the Dial Tone Line and usage services (Exh. VZ-5, at 3). Second, the analysis demonstrates the wide disparity in the relative levels of contribution for the Residence Dial Tone Line and usage rates when compared to either TELRIC, marginal costs, or TELRIC minus the loading for joint and common costs (*id.* at 3-4). Thus, using somewhat different measures of incremental costs, contribution from both the current and new Residence Dial Tone Line rates is still well below virtually all Residence usage services.

Ms. Brown's analyses confirm what the Department has concluded each time it has examined the Residence Dial Tone Line rate – it is well below an economically efficient level that would prevail in an unregulated competitive market. Moreover, because of the significant magnitude of the contribution disparities, Ms. Brown's analyses also demonstrate that the small 5 percent annual increase permissible under Verizon MA's Plan will not materially change the relationships for some time.

Significantly, there was no debate among the expert economists on the record that economically efficient pricing, under Ramsey pricing principles, would produce rates that place greater responsibility for the recovery of joint and common costs on services having the lowest elasticities of demand. The difference of opinion focused on whether the Residence Dial Tone Line is the most inelastic service.

Dr. Taylor and Dr. Mayo testified that the demand for residential customer access is highly inelastic both in an absolute sense and relative to other telecommunications services (Exh. VZ-6, at 21-22; Exh. ATT-2, at 10-12). Accordingly, they testified that: (1) economically efficient pricing would place a significant level of the firm's joint and common costs on the Residence Dial Tone Line, and (2) both the current and new rates are not efficient (*see e.g.*, Exh. VZ-6, at 21; Exh. ATT-2, at 10-12). The Attorney General's witness, Dr. David Gabel, argued

on the other hand that “it is no longer clear that the dial tone line charge is the non-elastic price element.” and contended that the Department would need detailed elasticity studies to make that assessment (Exh. AG-1, at 13-14). Both Dr. Taylor and Dr. Mayo refuted Dr. Gabel’s claims (Exh. VZ-6, at 22-23; Exh. ATT-2, at 11-12). However, it is unnecessary for the Department to sharpen its pencil – as Dr. Gabel suggests – to compute the precise elasticities for the Residence Dial Tone Line or other services.

Dr. Gabel does not deny that the Dial Tone Line was once the most inelastic service (Exh. AG-1, at 14). His argument is that the current competitive telecommunications market *may* have significantly changed the measure of *relative* elasticities for the Dial Tone Line compared with other services (*id.*). Dr. Taylor testified that this assumption is not only incorrect, but it is also irrelevant.

Dr. Taylor testified that Dr. Gabel correctly observed that wireless carriers, competitive wireline carriers and cable companies provide a variety of substitutes for Verizon MA’s Dial Tone Line, potentially increasing the firm-level elasticity of the service (Exh. VZ-6, at 22). However, Dr. Taylor testified that Dr. Gabel failed to consider that many of the same alternative services (*i.e.*, wireless and cable telephony) also provide substitutes for usage and other services provided by Verizon MA. Therefore, the same competitive activity cited by Dr. Gabel as likely to raise the Dial Tone Line price elasticity will also raise the price elasticity for *other* Verizon MA services (*id.*). Indeed, Dr. Taylor explained that “insofar as competitive alternatives for toll services emerged long before they did for dial tone service, it is likely that any movement towards a more elastic level would be greater for toll than dial tone service” (*id.*).

Moreover, even assuming some change in the elasticities for the Dial Tone Line and other services, there would have to be a complete reversal of *relative* elasticities with the Dial

Tone Line becoming the most elastic service to justify on economic efficiency grounds the grossly disproportionate level of contribution generated by the existing and new Dial Tone Line rates. Such a complete reversal of the historical elasticity relationships defies common sense, the Department's experience, and the extensive econometric literature, which has consistently indicated that the demand elasticity for the Residence Dial Tone Line is very low – very near zero (Exh. VZ-6, at 22; Exh. ATT-2, at 11). Simply put, telecommunications markets would have to undergo some unimaginable cataclysmic change to reverse the relative elasticities so as to justify, on the basis of economic efficiency, Dial Tone Line rates at the current or new levels. Dr. Gabel's effort to evade the facts regarding the elasticity of Dial Tone Line service relative to other services is unavailing.

Dr. Taylor testified that the Attorney General's claim that Residence rate changes should be deferred until formal elasticity studies are complete (*see* Exh. AG-1, at 14) is unreasonable and would effectively preclude pricing flexibility forever (Exh. VZ-6, at 22). He noted that obtaining precise and accurate measures of such elasticities requires knowledge of how demand for Verizon MA's services would change as its prices change *and* as the prices of Verizon MA's competitors' services change in response (*id.*, at 23). These parameters, in turn, depend on market conditions, such as the degree to which other services supplied by Verizon MA and by its competitors are substitutes or complements for the Verizon MA services in question. Dr. Taylor explained that it is practically impossible to obtain precise measurements of price elasticity in a dynamic competitive market (Exh. VZ-6, at 22-23).

Dr. Taylor testified that, while precise measures are impractical, we certainly have order of magnitude estimates regarding demand elasticities that can form the basis for pricing decisions (Tr. 1, at 27). He explained that greater precision is unnecessary because the data

presented by Verizon MA concerning the relative levels of contribution among services, provides a clear and unambiguous indication of the magnitude and direction that price changes for Dial Tone Line rates would take in a competitive market:

And I guess the answer is like this. I mean, we're standing at the bottom of a well, we don't know exactly how deep it is, but we know we have to go up; and that's the situation we have here ... That is, any increase in basic exchange rates is going to increase efficiency for a while, given that these ratios of margins are in the opposite direction of what they should be. So we've got a long way to go before you should be concerned that we're reaching an efficient level, and in particular, other concerns about basic exchange prices will probably come into play and will be determinative rather than the elasticities.

So I guess the bottom line is, I think you should move directionally. We all, I think, know what the right direction is, and a ceiling for residential basic exchange rate increases of 5 percent in nominal terms every year isn't going to get you beyond the point of efficiency any time in our lifetimes.

Tr. 1, at 27-28.

Dr Taylor also testified that firm or market demand elasticity measures are unnecessary – hence Dr. Gabel's conjecture about a possible change in the elasticity of Dial Tone Line is irrelevant – because the market is the best mechanism to signal if a price change exceeds the appropriate level. Dr. Taylor explained:

Allowing, but *not requiring*, that basic service rates can be increased by 5 percent per year provides Verizon the means to test the market. If an inappropriate price change is imposed, the market will respond by reducing Verizon's profits. It is not necessary to know the level of the service price elasticity because its effect on demand will occur regardless. Furthermore, market prices set this way will move in the direction of Ramsey prices insofar as the price of more inelastic services will recover relatively more contribution to the firm's fixed costs than will the price of a more elastic service.

(Exh. VZ-6, at 23).

In short, Dr. Taylor testified that the complex elasticity studies, as described by the Attorney General, are an *inefficient and unnecessary* approach here to obtain efficient prices. The competitive market is the best mechanism to signal if a price change exceeds the appropriate level.

The evidence Verizon MA presented about the magnitude of price increases in the Residence Dial Tone Line rate necessary to reach an economically efficient level clearly justifies more than a 5 percent annual increase in Basic service prices, consistent with the Department's tentative conclusion. The Plan's annual cap of five percent thus addresses any concerns about rate continuity. As Ms. Brown showed, that level of annual potential increase is well below the percentage price increases approved by the Department in the rate-rebalancing process started with D.P.U. 89-300 (Exh. VZ-2, at 10). It is also roughly comparable to the historic annual change in the Consumer Price Index so that basic residential prices at least keep pace with the long-term trends in national inflation. The Plan clearly moves toward the Department's goal of efficient pricing in a moderate and reasonable manner.

2. Competition Will Foster Efficient Prices More Readily Than Regulation.

Not only are Verizon MA's Residence Basic rates capped at a 5 percent annual increase, but competition in the Residence market will affect any of Verizon MA's price changes under the Plan. Although the Department did not specifically determine that the Residence market was sufficiently competitive, the Department acknowledged that there is existing competition for Verizon MA's residential services, and that competition for these services is growing. *Phase I Order*, at 104. If Verizon MA increases the prices of Residence Basic services beyond what the market will permit, competitors can and will compete even more vigorously for customers. (Exh. VZ-2, at 11).

The Department's implementation of the provisions of the Telecom Act has ensured that legal, regulatory and market based barriers to entry have been eliminated in Massachusetts. Indeed, competitive alternatives to Verizon MA's Unlimited Local Exchange service are available now to customers at prices that are comparable or less than Verizon MA's rates. A sampling of alternative offerings compared to Verizon MA's Unlimited Local Exchange service show the following:

Company	Offering	Present Price	Proposed Price
Verizon MA	Flat Rate	\$16.85	\$19.29
RCN	Plan 2	\$16.00	
AT&T	RightPak	\$19.25 ⁷	
Broadview Networks	Unlimited	\$15.17	
Plan B Communications	Flat Rate	\$16.01	

Exh. VZ-2, at 12 and Attachment B.

The presence of these competitive alternatives will limit Verizon MA's pricing flexibility, without incurring a market response (*id.*, at 12). As Dr. Taylor explained:

In markets where customers have a choice of suppliers, if Verizon MA were to attempt to price above the competitive market level, customers would switch suppliers and the attempted price increase would prove unprofitable. Even if there were Massachusetts markets where customers currently have no alternative source of supply, with low barriers to entry, a Verizon MA price increase would attract entrants as long as entrants could make a profit at the higher market price. Entry would then provide substitutes to which consumers could shift, and the contemplated price increase would again turn out not to be profitable for Verizon MA.

(Exh. VZ-3, at 15).

⁷ AT&T's RightPak service includes Call waiting and Caller ID at no additional charge, features that are not included in Verizon MA's Flat Rate service.

In light of existing competition throughout Massachusetts, the immediate threat of competitive entry and continued regulation of UNE prices and resale at a discount, Verizon MA's Plan effectively constrains its ability to raise prices for any retail residential service above the competitive market level.

3. Verizon MA's Plan Will Not Adversely Affect Universal Service.

The Department has compelling empirical data which establishes that neither the new Residence Dial Tone Line rate set as a result of revenue-neutral reductions in other rates or the potential for a 5 percent annual increase will have any impact on universal service. Ms. Brown testified that as a result of the rate-rebalancing effort undertaken in the early 1990's in accordance with the Department's orders in D.P.U. 89-300, Verizon MA lowered usage charges (local, toll, and access), while substantially increasing Dial Tone Line rates for business and residence customers (Exh. VZ-2, at 10). She testified that Verizon MA made the following changes in the Residence Dial Tone Line rate between 1990 and 1994:

Year	Starting Rate	New Rate	\$ Increase	Percent Increase
1990	\$1.19	\$4.50	\$3.31	278%
1991	\$4.50	\$5.62	\$1.12	24.9%
1993	\$5.62	\$7.42	\$1.80	32.0%
1994	\$7.42	\$9.91	\$2.49	33.6%

Exh. VZ-2, at 10.

These Dial Tone Line increases had no impact on universal service. The FCC-reported residential subscriber penetration in Massachusetts remained at about the same level over this period – 96.6 percent in 1990 and 96.5 percent in 1994 (*id.*). Thus, despite a total increase in the Dial Tone Line rate of over 730 percent, the telephone penetration rate was essentially unchanged. Since 1994, the penetration rate in Massachusetts has remained high, and now

stands at 95.9 percent (Exh. AG-2, at 12). Experience with significant rate changes shows that the Residence Dial Tone Line rate can be increased substantially – even in a relatively short period – to more economically efficient levels without negatively impacting residential subscriber penetration.⁸

Moreover, since 1994, Verizon MA has not changed the Residence Dial Tone Line rate or rates for any of other Residence Basic service (AG-VZ RR-1). Thus, over the past seven years, the prices for these services fell in real terms (Exh. VZ-3, at 15). The rates for Residence Dial Tone Line and local usage also dropped over this period as a percentage of total per capita income in Massachusetts (Exh. ATT-6). For example, in 1995, Verizon MA's average Residence Dial Tone Line and usage charges were \$16.85 per month, representing 0.76 percent of real per capita income of \$26,559. By 2001, Dial Tone Line and usage charges in real terms were \$14.10, representing a reduction from 0.76 to 0.52 percent of real per capita income of \$32,230 (*id.*).

In summary, significant Dial Tone Line rate increases in the past have not affected subscription levels for Residence Basic services, and the rate changes permissible under the Plan are extremely small in comparison to those past changes. Telephone penetration rates in Massachusetts have been constant, at levels consistently above the national average, during periods of both substantial rate increases and rate freezes. The record evidence shows that Verizon MA's Residence services are more affordable today than in the mid-1990's. In addition, Verizon MA's Plan maintains rates for LifeLine customers at existing levels. This targeted

⁸ Dr. Gabel noted that, although the penetration rate for Residence service in Massachusetts is *above* the national average, the rate did not increase from 1997 to 2001, whereas the national average increased by 0.5 percent over that period (Exh. AG-2, at 12). He also noted that the Massachusetts penetration rate is lower than in neighboring New Hampshire, which has the highest penetration rate in the country at 98.1 percent (*id.*). These observations establish nothing about the actual or potential impact of rate changes in Massachusetts. The most relevant data on this issue is the actual experience during and after the significant

assistance program ensures that customers least able to afford telephone service will continue to have low-cost basic service. Verizon MA's Plan fully satisfies the Department's goal of universal service.

B. Verizon MA's Proposed Regulatory Treatment of Residence Non-Basic And New Services Is Reasonable.

The Plan proposes that the Department continue to grant Verizon MA flexibility to price Non-basic services based on market conditions and revenue-maximization. *Phase I Order*, at 104. This finding is consistent with the Department's findings in D.P.U. 89-300 and D.P.U. 92-100 where the Department ruled:

Given the continuity and universal service considerations for residential rates, the Department finds it appropriate to continue to use the revenues from the sales of these discretionary adjunct services to dampen the impact on basic residential telephone rates. (D.P.U. 89-300, at 146)

And regarding the pricing of auxiliary or discretionary services, the Department stated:

...the Department still considers it appropriate to afford NET a reasonable amount of discretion in pricing these services. (D.P.U. 92-100, at 62)

Dr. Taylor confirmed that the Department should continue this policy. He testified that the extent of competition established on the record of this docket "is compelling evidence that in order to have symmetric competition among all the competitors, that pricing flexibility [of new services] is warranted" (Tr. 1, at 19). Dr. Taylor explained that "[e]ncouraging pricing and marketing flexibility for the incumbent firm—permitting it to respond to market changes—is essential in fostering a dynamic competitive market with consumer choice of supplier and technology" (Exh. VZ-3, at 9). Verizon MA's Plan furthers the Department's objective to allow

Dial Tone Line increases here between 1990 and 1994. As the data shows, Massachusetts telephone penetration rates varied little from year to year either during or after those significant increases.

market forces to establish competitive prices for telecommunications services and should be approved.

Verizon MA also proposes to treat new services as it would treat services in the Non-Basic service category of its Plan. Rates and charges for new retail services Verizon MA offers under tariff will be initially set and subsequently increased or decreased in response to market conditions at the discretion of the Company. New services, by definition, are not essential, and are offered to fulfill an identified demand niche or in response to a service introduction by a competitor. There is no economic or policy basis to constrain Verizon MA's prices of such services. Indeed, Dr. Taylor testified that such flexibility will further competition and benefit consumers:

You certainly do need pricing flexibility. One characteristic of new service is that you don't know precisely what the market characteristics are, what people are willing to buy, how much they're willing to pay, what form they would like the tariff to look like, what packages they'd like to see. And that requires a lot of experimentation. And if you constrain the price of new services, bring a new service out, charge ten dollars and then to raise it to twenty dollars is unthinkable, would be a big mistake. You could easily misprice a service by 100 percent for new services. (Tr. 1:19)

Since existing Residence Basic services remain available at prices constrained by the 5 percent annual rate cap, consumers are protected and cannot be harmed by pricing new services at any particular level. (Tr. 1:20.) No party questioned this component of Verizon MA's Plan, and it is entirely reasonable that Verizon MA be allowed to treat new services as proposed.

C. Although a Service Quality Plan Is Unnecessary, If the Department Requires a Plan, It Should Mirror the Plan Adopted in D.P.U. 94-50.

Based on the existing level of competition for telecommunications services in Massachusetts, there is no longer a need for the Department to impose retail service standards and penalties on any carrier, including Verizon MA. The competitive market, rather than

regulation, is the most efficient structure to impose such discipline on the quality of service provided by competing service providers (Exh. VZ-4, at 1-2). Carriers that provide the level of service customers want will be rewarded with a growing share of the market, while providers of lesser quality service will not retain or attract customers. No party to this case introduced any evidence showing that a retail service quality plan was necessary to ensure that Verizon MA continues providing high quality service to its customers. Accordingly, the Department should not single-out Verizon MA to be the only telecommunications carrier in Massachusetts subject to retail service standards.

If the Department decides, however, that it is necessary to continue a service quality plan, Verizon MA proposes that the Department retain, with a slight modification, the Service Quality Plan adopted under the Price Cap Plan in D.P.U. 94-50. The Service Quality Plan adopted by the Department in D.P.U. 94-50 consists of 12 service measures in three categories: (1) Installation Service; (2) Maintenance Service; and (3) Service Response (*id.*, at 3-4). The Service Quality Plan adopted in D.P.U. 94-50 requires modification because the penalty provision required an increase in the productivity offset of one-twelfth of 1 percent if certain service levels were not met (*id.*, at 5). Since Verizon MA's current Plan does not include a productivity offset, it is necessary to adopt a new mechanism that provides the same relative penalty level (*i.e.*, one-twelfth of one percent of annual retail revenue for every month that either the overall performance level is less than 33 points or if three or more of the 12 individual service items that comprise the Service Quality Index fall below the standard threshold on a statewide basis in a given month). The penalty would be paid as a one-time credit to all Verizon MA residence and business lines on an annual basis (*id.*).

III. THE ATTORNEY GENERAL'S CRITICISM OF VERIZON MA'S PLAN IS WITHOUT MERIT.

The Attorney General's witness recommended that the Department freeze Residence Basic rates at current levels, arguing that the Department lacks adequate support to approve Verizon MA's Plan (Exh. AG-1, at 5). Dr. Gabel essentially takes the position that no rate increase is appropriate absent the submission of a traditional, embedded cost-of-service study (*id.*, at 14-15). Dr. Gabel also presented various arguments regarding the efficient pricing of telecommunications services which focused mainly on his claim that the Residence Dial Tone Line may no longer be an inelastic service that should be increased under Ramsey pricing principles. Verizon MA addressed his contentions regarding efficient pricing above. Here, Verizon MA addresses Dr. Gabel's other major contentions.

A. The Attorney General's Recommendation That the Department Freeze Basic Residential Rates Pending a Traditional Cost-of-Service Study Is Without Merit.

The Attorney General contends that any potential for an increase in Residence Basic services rates is unwarranted because the current rates exceed their embedded costs (Exh. AG-1, at 14). His argument is without merit and would have the Department apply a cost standard for setting rates that the Department abandoned in D.P.U. 94-50, when it adopted price caps.

Dr. Taylor testified that an embedded cost analysis is by definition a historical cost analysis and as such should not be confused with forward-looking costs and/or economic efficiency – a key Department telecommunications policy goal (Exh. VZ-6, at 24). As the Department has already affirmed:

we can look to principles of competitive pricing for standards to judge whether regulated prices for specific services are just and reasonable. In competitive markets for telephone services, efficient market prices are based on incremental cost plus a mark-up for joint and common costs, based on Ramsey pricing principles.

Phase I Order, at 101.

Embedded cost analysis, which relies upon historical costs, is a regulatory tool only applicable, if at all, in a monopoly environment, and is not an appropriate measure of just and reasonable retail rates in the current competitive market for telephone services (Exh. VZ-6, at 24). Indeed, as Dr. Mayo pointed out, even in a monopoly environment, Residence rates were set on a residual, not a cost, basis, and he explained, “[o]nly in the most nominal and somewhat surreal sense have basic residential rates ever been judged relative to costs (Exh. ATT 2, at 2).” Dr. Mayo noted that “performing another traditional cost of service study for the purpose of establishing local residential rates should be seen as having limited and questionable value, because the allocation methodologies of such an approach produce costs and rates that are inconsistent with cost-causation principles and, therefore, the development of competition”(*id.*).

The Attorney General further suggests that allowing Residence retail rates to rise without reference to recent underlying cost justification violates the regulatory principle that Department-approved rates should be based on supporting cost data and prevents the Department from ensuring that the rates will approximate the result that would “obtain in a competitive market” (Exh. AG-1, at 5). The Attorney General’s argument is clearly without merit.

One of the Department’s goals for this proceeding is to determine how Residence prices should be set to reflect a more competitive market, not a natural monopoly market (Exh. VZ-6, at 3). The Telecommunications Act of 1996 radically changed the local exchange markets by opening them to robust competition. The Department, the FCC and the Justice Department have found that those market-opening objectives have been successfully implemented in Massachusetts (*id.*). Dr. Taylor testified that there is far too much competition for the provision

of Residence Basic services in Massachusetts to conclude that natural monopoly conditions prevail and to retreat to outmoded cost-of-service regulation (*id.*).

Indeed, even Dr. Gabel unambiguously acknowledged the availability of multiple competitive alternatives for Dial Tone service in Massachusetts.

4.3 Residual Pricing No Longer Makes Sense Due To The Increasing Availability Of Substitutes For Traditional Wireline Service

[I]n the current competitive environment . . . [t]here are now wireless carriers, competitive wireline carriers, and cable companies offering service that compete with the standard dial tone. In addition, digital subscriber line service competes with dial-tone line service.

(Exh. AG-1, at 13-14).

In markets characterized by competition, the forces of demand and supply will determine the *efficient* level of price (Exh. VZ-6, at 27). There is no need to judge the reasonableness of prices in such markets with any reference to allocated, embedded costs, as the Attorney General suggests. Dr. Taylor testified that the most effective way to assure that rates “reasonably approximate” those that would be obtained in a competitive market – which is the goal of regulation – is to allow the market to determine the rates. Ms. Brown’s detailed contribution analyses demonstrate that the Residence Dial Tone Line rate provides far less contribution to the recovery of joint and common costs than virtually all other services. This is neither fair nor economically efficient and is not a result that would prevail in an unregulated competitive market. The Plan provides Verizon MA with some pricing flexibility to set Residence Basic service rates at more efficient competitive levels, if market conditions warrant. And, given the 5 percent annual rate cap on Basic Residence services, the movement toward more efficient pricing

will be very gradual until such time as the Department finds that there is sufficient competition in the Residence market to permit full market-based pricing.

B. Contrary to the Attorney General's Claim, Verizon MA's Plan Is Not Based On the Assumption That Residential Rates Are Currently Being Subsidized.

According to the Attorney General, Verizon MA's Plan erroneously assumes that "residential rates are subsidized by access charges" (Exh. AG-1, at 6), and therefore, any potential increase in Basic Residence rates is unwarranted. Here too, the Attorney General is wrong, and once more relies on an outdated traditional embedded cost analysis to review the Plan.

Verizon MA's Plan neither assumes that Residence services are subsidized nor is it dependent upon there being any such subsidy (Exh. VZ-6, at 5). Dr. Taylor testified that a service is subsidized if its price does not recover the forward-looking direct costs incurred to provide the service (*id.*). Ms. Brown testified that essentially all Residence services provided by Verizon MA are priced in excess of the forward-looking direct cost required to provide them and thus are not subsidized (Exh. VZ-5, at 4). The issue here is not whether the services are subsidized but whether the potential for even very modest increases in Residence rates – a maximum of 5 percent annually as proposed – would prevail in an efficient, competitive market. *See Phase I Order*, at 101 ("In competitive markets for telephone services, efficient market prices are based on incremental cost plus a mark-up for joint and common costs, based on Ramsey pricing principles"). As discussed, Ms. Brown established that the Residence Dial Tone Line rate is not providing the same level of contribution to joint and common as virtually all other Residence services (Exh. VZ-5, Attachments A and B). Therefore, her analyses demonstrate that the Dial Tone Line rate is far below an efficient market price.

C. Contrary to the Attorney General's Claim, Verizon MA's Pricing Proposals Are Consistent With Economic Efficiency.

The Attorney General contends that Verizon MA's Residence Basic service pricing proposal is not consistent with economic efficiency (Exh. AG-1, at 16-22). Initially, Dr. Gabel notes his disagreement with the Department's assertion that any price within the range of incremental cost and stand-alone cost could prevail in an efficient, competitive market (*id.*, at 16). Later, he states that "[i]t is true that these prices can be expected to lie between incremental and stand-alone costs, but it is not true that any price in this range is possible" (*id.*). According to the Attorney General, in any specific market "only a very narrow range" of prices would typically be possible market outcomes. The Attorney General's position is one of semantics only, providing no real economic critique of Verizon MA's pricing proposal in this proceeding.

Of course, the Department's statement should only be taken to mean that an efficient price in a competitive market is expected to lie somewhere between incremental and stand alone costs. Although it is possible that any price between incremental and stand-alone cost *might* be Ramsey-efficient, not every price in that range is necessarily Ramsey-efficient (Exh. VZ-6, at 25).

The fact is that in the current competitive telecommunications market, the collective actions of consumers and competing suppliers determine what the prices ought to be. The sustainable prices that emerge as a result then simulate the outcomes from a pure Ramsey pricing exercise (*id.*, at 29). As a result, regulators will achieve Ramsey-like efficient prices by granting Verizon MA's Plan for pricing flexibility.

The real virtue of competition is that efficient or just and reasonable prices do not have to be picked arbitrarily from the wide array of possibilities represented by the range between incremental and stand-alone costs; rather, the collective actions of consumers (especially those differently situated) and competing suppliers determine what those prices ought to be. The presence of

viable competitors acts as a policing mechanism that keeps the incumbent's prices in check.

(Exh. VZ-6, at 27). Even large changes in the incremental costs of providing residential exchange service and usage services do not affect the conclusion that higher residential exchange prices will increase economic efficiency. Arguing that a cost showing is required prior to changing rates in markets that Dr. Gabel himself characterizes as subject to “the availability of substitutes” is nothing more than a veiled attempt to forestall price changes for virtually all time.

D. The Attorney General Erroneously Contends That the Local Loop Is a Shared Facility and Its Cost Should Be Allocated Among other Services.

Consistent with his traditional and outdated cost-of-service ratemaking theme, Dr. Gabel argues that loop costs should not be recovered exclusively from Residence Basic services but should be allocated among all services that can be provided over the facility because: (i) the loop is not a separate service; and (ii) the loop increasingly is being used to provide additional telecommunications services (Exh. AG-1, at 9-13). His position is without merit and should be rejected by the Department.

Dr. Gabel's belief that the local loop is a shared facility is widely rejected by economists because it conflicts with the fundamental principle of cost causation (Exh. VZ-6, at 9). That principle assigns the responsibility for the costs associated with the loop to the customer who causes the costs of the loop to be incurred. Dr. Taylor explained that the costs associated with a loop are caused by a customer gaining connectivity to the network. He noted that the incurrence of these costs is unchanged whether the connectivity is gained as part of a standard bundled offering like Basic Exchange service (which bundles the loop and local usage) or, in the new environment of the Telecommunications Act of 1996, by purchasing an unbundled loop (*id.*). Actual use of the loop is irrelevant for cost causation because a customer that purchases (or leases) the loop essentially acquires the *right* (together with the associated cost *responsibility*) to

access the network and receive (or not receive) services of his choosing. The loop has been provisioned ? and a cost incurred ? regardless of whether the customer uses the loop at all, uses only one service, or uses multiple services (*id.*). Therefore, the cost of that loop must be recoverable regardless of actual use.

As Dr. Taylor testified, Dr. Gabel's notion that the cost of the loop should be recovered from customers depending on *how* the loop is used (*see* Exh. AG-1, at 10 (“[a]s a common input, loop costs should be supported by all of the services that depend on the loop”)) leads to incongruous results. For example, if the cost of the loop should be recovered from different customers depending on how many services they use (including none at all), then each service that *could be* carried over the loop would somehow be assigned its share of the loop cost to recover (Exh. VZ-6, at 14). However, Dr. Taylor explained that there are essentially an infinite number of variations in customer usage patterns, thereby necessitating the use of broad averages instead. This would require an estimate be derived of the average usage levels of all services and the associated average usage shares of the total loop cost (*id.*). In addition to the significant practical obstacle that average revenue shares for all services could somehow be determined, additional loop cost recovery charges on those services would have to be added on those services in the same proportions as the average usage shares, even though those services do not, in and of themselves, generate loop costs. After all this, Dr. Taylor testified that the following three problems would still remain:

1. Those charges would have to be adjusted periodically (every month? year?) as the average usage shares themselves changed.
2. Changing relative prices of the services could change the average *revenue* shares themselves even without any change in the underlying average usage measured in physical units. Therefore, some kind of complicated index would have to be used instead.

3. Customers with usage patterns different from the average would end up either subsidizing other customers or being subsidized. This would, in turn, be accompanied by distortions in the economically efficient levels of consumption of the services.

Id. at 15.⁹ Put simply, the allocation of the cost of a loop to different services that can be provided over it has no economic validity. It results in improperly derived rates: (i) based on an estimate of the share that each service should carry; (ii) uses arbitrary allocators that have no economic justification (*i.e.*, should a non-usage-sensitive cost be recovered through usage sensitive charges?); and (iii) may require untenable and unenforceable burden sharing among different service providers (LECs, long distance carriers, and other competitors) (*id.* at 14-15).

Rather than improperly equating shared cost with shared use, the correct economic principle treats a loop facility as a provider of connectivity to the network, which is a service in its own right with its own unique cost and price (*id.*, at 10). Once a customer acquires network connectivity (a loop), other services can be made available to that customer only at *additional* cost. For example, provision of toll service to a customer would cause the network to incur a cost that is separate from that for the loop. Therefore, the loop or dial tone service cannot be a joint or shared cost (*id.*, at 11).

The cost-causation principle guides economically efficient pricing of the loop. Only a price reflecting the full economic cost of the loop ensures the socially optimal level of use of that facility (*id.*, at 13). If the loop is part of a bundled basic residential service, then the full economic cost of the loop should be a part of the cost of that bundled service. The Attorney General's artificial distinction between the local loop and the dial tone service is without merit

⁹ The use of arbitrary allocators would also require a return to the economically indefensible (and therefore discredited) regulatory practice of collecting non-usage sensitive costs (*i.e.*, the cost of a loop) through usage based charges. Such an allocation violates basic principles of cost recovery and rate design (Exh. VZ-6, at 15).

(see Exh. AG-1, at 13). Properly viewed, they are one and the same from the perspective of how the costs are incurred on the system (as a single unit), as well as from the perspective of how the loop and associated dial tone are provisioned by the local exchange carrier (*id.*). Accordingly, Dr. Gabel's contention that the local loop should be priced as a shared facility is without merit.

Dr. Gabel claims that the FCC has itself recognized that the local loop is a source of common cost that should be shared (Exh. AG-1, at 9). He argues that the manner in which the FCC conducts its price-squeeze examination in Section 271 proceedings establishes that the cost of the local loop is shared (*id.*, at 10). Dr. Gabel's analysis of the FCC's policies is simply wrong.

The FCC has clearly demonstrated that it understands that economic efficiency is reduced if non-traffic-sensitive ("NTS") costs (*i.e.*, the cost of the local loop) are recovered using traffic-sensitive ("TS") prices – precisely the result that Dr. Gabel's theory would produce. For instance, the FCC has noted that: "A rate structure that recovers NTS costs through per-minute charges creates an incentive for customers to underutilize the loop by requiring them to pay usage rates that significantly exceed the incremental cost of using the loop." *In the Matter of Access Charge Reform*, CC Docket No. 96-262, First Report and Order, May 16, 1997, at ¶ 69.

The FCC's decision to recover the cost of dedicated facilities (e.g., subscriber line charge) that are NTS in nature through separate flat-rated charges assessed directly on end-user customers removes any uncertainty about the FCC's reliance on cost causation to establish proper cost recovery for local loops. The fact that the local loop can be used in several different and simultaneous ways has no effect on cost recovery, which is driven solely by how the cost is incurred (Exh. VZ-6, at 17).¹⁰

¹⁰ With respect to the recovery of the cost of UNEs, the FCC again expressed clearly its requirement that costs of dedicated (activity specific) facilities "including, but not limited to, charges for unbundled loops,

IV. CONCLUSION

For the reasons stated above, the Department should adopt Verizon MA's Plan. As the record demonstrates, providing Verizon MA with the ability to increase rates for Residence Basic services by a modest 5 percent annually furthers the Department's goal of more market-based and efficient pricing of telecommunications services. Residence Basic service prices are well below efficient competitive levels, and such prices forestall competitive entry to the detriment of all consumers in Massachusetts. At the same time, Verizon MA's Plan furthers the Department's goal of universal service by maintaining the rates for LifeLine customers at the existing rate levels so that customers who cannot afford service will see no increase in their rates. Verizon MA's Plan will result in just and reasonable rates, consistent with the policy objectives that the Department has traditionally used for assessing changes in regulatory requirements.

Respectfully submitted,

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dedicated transport, interconnection and collocation" be recovered on something other than a usage basis (Exh. VZ-6, at 16, citing *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order, at ¶ 744 (August 8, 1996).